1950

Monthly Letter on
Economic Conditions Government Finance

New York, November, 1950

General Business Conditions

THE armament program, while still only in the beginning stages, is gradually fastening its grip upon the business of the country. The most significant development of the past month has been the issuance by the Federal Reserve Board of the revised Regulation W tightening restrictions on the use of credit for consumer purchases, and of Regulation X requiring more rigorous terms on purchases of new houses than have prevailed in this country for many years. Construction of entertainment facilities has been curbed. A cutback in the consumption of rubber has been ordered, limitations on the use of aluminum and copper are being drawn at this writing, and allocations of steel are commencing, with railway car construction as the first main beneficiary. These are in addition to priorities for armament orders themselves. All are measures reminiscent of the war years. Their purpose, now as then, is to repress civilian buying and to assure a supply of materials and labor for armament needs. By curtailing demand, they diminish inflationary pressures.

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These restrictions are severe. Regulations W and X in particular have been protested vigorously by many people affected, on the ground that they are at least premature, and that they will create unemployment in civilian business more rapidly than the workers can be absorbed in armament production. Of course they are intended to be severe. The Reserve Board has stated that its purpose is to hold new housing starts in 1951 to around 800,000, compared with a probable 1,300,000 this year. However, there is no way to forecast precisely whether the new credit terms will reduce starts to 800,000 or 600,000 or 1,000,000. Nor can the effects of Regulation W on output of consumers' durables be prejudged exactly.

Thus it is reasonable to expect the authorities to be ready to modify the regulations if the results turn out wide of the intent. A basic principle to be observed in the armament program is that it is not a spurt, but an effort which may have to be kept up for many years. To allow resources to go unused and workers to be unemployed through mismanagement would weaken the productive power of the country and its capacity to sustain the effort.

Purpose of the Regulations

On their part, the critics should understand and acquiesce in the purpose of the regulations. No one is prevented from producing, selling or buying the goods in question, but only from using credit for purchases to the same extent as heretofore. The stiffer terms will restrict demand. However, the industries affected have been turning out their products in much the greatest volume in all their history, and it is not now possible, even in the United States, to produce the arms needed and at the same time carry on the output of these goods at recent levels. The consumers' durable goods industries use huge amounts of scarce raw materials; for example, new houses and automobiles probably will consume at least

350,000 tons of copper this year. Reduction in demand for these goods will free copper, steel and other essentials for the defense program. These industries are also large employers of labor, including in automobiles and household equipment perhaps the greatest single reservoir of workers with the skills and experience needed in certain types of arms production. The construction industry during the past summer has used some 2,600,000 workers, automobile factories about 900,000, furniture and household equipment and appliances upwards of 500,000.

The final consideration is the large and constantly rising volume of credit which buyers have been using for the purchase of homes and durable goods. This borrowing has contributed to the expansion of the money supply and to the upward pressure on prices. It has been an inflationary factor, and to restrain inflation vigorous action is necessary. The alternatives to restrictive credit policies are either direct regimentation, or continuing inflation.

Expectations of Slackening

Actually most people have wondered whether these industries could possibly sell all their output if they continued to produce at the 1950 rate. If, as many believe, markets were approaching a temporary saturation, curtailment would follow in 1951 irrespective of credit restriction. From this point of view the regulations only make a decline in activity more certain.

In other industries also expectations of slackening are encountered. Many manufacturers of consumer goods say they have been producing and shipping more than is being consumed. They see larger stocks in distributors' hands and think there is more in pantries and closets also. They are prepared to see some reaction in the wake of the enormous buying of last summer and the enormous output and shipments that have followed during the autumn.

These expectations raise questions as to how general this situation is, what are the offsetting factors, and how soon will armament orders reach large enough volume to take up slack. In some sections of the economy likelihood of a letdown is remote. Fears of overstocking or the effects of borrowing from the future do not apply to the capital goods industries, for in the main they continue to receive large orders and now have heavy backlogs. The upturn in the machine tool and railway equipment business has been sensational. Construction will not slacken rapidly, but slowly, due to continuing work on the high volume of contracts outstanding. In September the number of housing units started, 115,000, was 12,000 more than in September a year ago and the highest in any September of record, although 26,000 below the August total. Total building contract awards in the first three weeks of October were 18 per cent above a year ago.

In soft goods it is a reasonable surmise that stocks of staple merchandise will not be pressed on the market at sacrifices, even though inventory accumulation may be carried no further and orders reaching manufacturers may fall off. The prospect of inflationary pressures over the long run influences buyers to carry good-sized stocks, just as it has obviously influenced people to spend rather than save. Looming ahead, and becoming larger each month, are the armament orders. Their prospective size is still not accurately known, especially for the fiscal year 1952, but the general assumption is that defense expenditures by next June will be approximately twice the current rate. This signifies an increase in demand of at least $15 billion, annual rate.

In current business news little to indicate a recession, other than a softening of automobile demand and of lumber prices, has appeared during October. The trend of commodity prices, both staples and manufactured goods, has been upward. For a time a rise in the price indexes was interrupted by declines in foods and farm products, but the advance in manufactured goods, where rising wage rates as well as raw material prices are the dominant influences, has been steady. The evidence still is that the problem of the country is to restrain inflation. The possibility of a slackening in business activity in the months just ahead does not remove the danger or warrant complacence. It merely emphasizes that there is also another problem — to gauge how far and how fast to go with measures designed to repress demand.

A Milestone in U. S. Foreign Trade

August trade figures, published during the past month, mark something of a milestone in the foreign trade of the United States. Our imports set an all-time record of $819 million, almost 50 per cent above the 1949 monthly average. Even more noteworthy, for the first month in thirteen years we imported more than we exported, counting in our exports not only what we sold but what we gave away. Only in three years in the past seventy-five have we had an excess of imports. There is small chance that 1950 as a whole will show such a result, but the change since 1947, when our export surpluses averaged nearly $1 billion a month, has been sensational. The clos-

ing of the gap was speeded up by the widespread currency readjustments in September 1949, and again last summer by the outbreak of the Korean war. Under the influence of the upswing in business activity at home, and the demands of the rearmament and stockpiling programs, the dollar market for foreign goods has expanded to unprecedented figures. With coffee at 50 cents a pound, rubber at 65 cents, wool up to $2.50, the raw material producing countries are making outstanding gains in their dollar earnings.

The effect on our trade of the powerful stimulus to imports stands out even more clearly if the shipments of goods financed under the European Recovery Program and the Mutual Defense Assistance Program are excluded from our exports. Making this adjustment to what may be called a "cash-and-carry" basis, we have had an almost uninterrupted series of import excesses ever since January. In August, the excess of imports in cash trade apparently exceeded $200 million, compared with the figure of $58 million for over-all trade. In addition to paying over $200 million for the excess of cash imports, we also paid out about $60 million for "offshore purchases" made in Canada, Latin America, and other parts of the world for account of European countries participating in the Marshall Plan.

Striking as the August figures are, it would be premature to conclude that import surpluses will continue, for it is reasonable to expect an increase in U.S. exports as a consequence of the alleviation of the dollar shortage, provided the export demand can be supplied. Except for allocations of strategic materials and tariffs, there will be no restrictions on the exchange of goods between the United States and Canada after January 1. Among the "overseas" sterling area countries which cut their dollar imports drastically in the fall of 1949, South Africa and Australia are reported to be considering the admission of more dollar goods. Import permits are being granted more liberally by Latin American countries and the barter deals in which some of these countries engaged only a few months ago have lost most of their attraction now that dollars are in larger supply.

The export figures also are bound to be swollen during the coming months by the exports of military equipment financed under the Mutual Defense Assistance Program, for which $5 billion has been appropriated by Congress. In the raw material producing countries generally, it is logical to expect that more liberal imports of capital and consumer durable goods will be wanted from this country, once their monetary reserves are replenished.

Wages and Living Costs

On October 20 Mr. Stanley H. Ruttenberg, Director of the Department of Education and Research of the Congress of Industrial Organizations, addressed to the editor of this Letter, and also sent to the press for general publication, a communication referring to statements made in our October issue concerning wages and living costs. Summaries of Mr. Ruttenberg's letter appeared in various newspapers. The full text follows:

Mr. Ruttenberg's Letter

Dear Sir:

In your October Letter on Economic Conditions, you state that "inflationary pressures have been augmented by a flood of wage increases, which has already engulfed much of the country's industry and plainly will engulf more." The impression is given that wage increases are the major cause for price rises.

There is no basis for this view of the current economic situation, in my opinion. There was no significant pattern of major wage increases in the period immediately preceding June 24. The flood of price rises that engulfed the nation in the weeks that followed the Communist invasion of South Korea were not due to wage boosts. I think that you would have to look to other quarters to find the sources for the inflationary pressures of recent months.

There was a rush of speculative manipulation in the commodity exchanges as soon as the Korean war started. Prices of 28 basic commodities, which had risen an average of 1.4 per cent per month between January 3 and June 23, advanced 10 per cent in one month following the invasion of South Korea. The all-commodity index of wholesale prices during the first six months of 1950 went up by less than eight-tenths of one per cent a month, but since June 26 has jumped 7.5 per cent. In 16 weeks from the date of the Communist aggression in South Korea to mid-October, the price of crude rubber rose 154 per cent; print cloth, 62 per cent; wool, 55 per cent; lard, 45 per cent; cotton 22 per cent.

Certainly, wage and salary earners cannot be blamed for the speculation on the commodity markets. On the other hand, working people are paying and will pay for such speculation, in the form of increased consumer prices.

You state that "the contention of the unions relating to living costs disregard simple facts." Your own statement admits, however, that retail prices in mid-August, the latest date for available information, were higher than at any other time, except for a brief period in 1948. The full impact of skyrocketing prices on the commodity exchanges has not yet been felt. In the coming months, those price boosts will be translated into increases at the corner grocery. By then, seasonal factors that kept down food prices will be gone, and living costs can be expected to zoom to new record heights.

Wage increases now requested by unions, in your opinion, "exceed any basis of parity with living costs that has existed in the past." The record shows otherwise. From 1944, the wartime peak, to the first half of 1950, the buying power of average weekly earnings in manufacturing industries fell more than 7 per cent.

Price increases and the decline in the work-week since the war have cut into the buying power of wage earners.

You now state that the mobilization effort "must in some degree reduce living standards below what they might be." The question arises whether you would want to see wage and salary earners bear the major burden of the mobilization program.

While the buying power of wage earners' weekly income declined since the war, productivity per man-hour increased. Obviously, management has failed to share with wage earners the benefits of improved efficiency. Business also failed to share the savings from increased productivity with the consuming public.

As a result of these business policies, corporate profits have reached all-time records in the postwar period. From the 1944 wartime high-point of $10.8 billion after taxes, corporate profits zoomed upward to $20.9 billion after taxes in 1948.

At present, business is enjoying an unprecedented boom. By last Spring it was assured of a peak year. Events that have followed the Korean war point to a new all-time record. Corporate profits after taxes, this year, are expected to reach $23.4 billion.

Pay increases for the nation's wage and salary earners can be obtained out of these booming profits and increasing productivity. Corporate enterprise can well afford to increase wages without passing them on in the form of price rises.

Should wage increases create an excess of effective demand as compared with the supply of civilian goods in this mobilization period, I am confident that American workers will vigorously respond to a stepped-up government E-bond drive. This occurred during the last war, when the strain on the economy was very great, and there is no reason to doubt that patriotic American wage and salary earners would do less in this mobilization to defend our national security.

Very truly yours,
STANLEY H. RUTTENBERG

Mr. Ruttenberg is an official representative of the C.I.O., and the release of his letter to the press shows the interest of the C.I.O. in presenting to the general public its case for the wage demands it is making. We welcome his letter and in the interest of full and fair discussion are glad to give it space.

Causes of the Price Rise

The first part of Mr. Ruttenberg's letter is devoted to a refutation of an "impression"—which he says our Letter gave — that wage increases have been the major cause for price rises since the Korean war started. This refutation actually is unnecessary, for our Letter neither stated nor implied that wage increases caused the advances in basic commodities to which he refers. Our statement was that inflationary forces have been *augmented* by wage increases, because "the effect is to raise costs and force up prices of manufactured goods."

The rise in basic commodities was due to demand inspired by a sharp increase in buying of products made from these commodities, and also to the clear indication that more of them would be needed in the future, which naturally prompted buyers to cover their needs further ahead. To whatever extent this buying was borrowed from the future, or was "speculation" as Mr. Ruttenberg says, the advance could be expected to correct itself. Wage increases, however, turn the movement into a spiral of rising costs, prices, and perhaps wages again.

Of course, union members do not consume directly crude rubber, print cloth, wool, cotton, or most of the other basic commodities in the indexes mentioned by Mr. Ruttenberg. They consume goods produced from these commodities, in which many other costs enter, notably labor costs. The purchasing power of the pay envelope therefore is measured not by indexes of basic commodity prices but by the index of the cost of living. Mr. Ruttenberg predicts further increases in living costs, but this is opinion and not evidence. He does appeal to the record, however, in taking exception to our statement that "increases now being sought and granted exceed any basis of parity with living costs that has existed in the past." He says the record shows otherwise, and that from 1944 to the first half of 1950 "the buying power of average weekly earnings in manufacturing industries fell more than 7 per cent."

Higher "Real" Wages

The record of changes in wages and living costs is one that interested persons can readily obtain and study for themselves. Excellent statistics are presented in the monthly reports of the Bureau of Labor Statistics of the U. S. Department of Labor, which is the recognized authority. Changes since 1944, covering the manufacturing industries, are shown in the following table:

	Consumers Price Index 1935-39 =100	Consumers Price Index 1944 =100	Average Hourly Earnings Actual	Average Hourly Earnings Real*	Average Hours Per Week	Average Weekly Earnings Actual	Average Weekly Earnings Real*
Ave. 1944	125.5	100.0	$1.019	$1.019	45.2	$46.08	$46.08
Sept. 1948 peak	174.5	139.0	1.386	.997	39.8	55.16	39.68
Ave. 1st half 1950	167.8	133.7	1.432	1.071	39.9	57.09	42.70
August 1950	173.0	137.8	1.464	1.062	41.2	60.32	43.77
September 1950	173.8	138.5	1.480	1.069	40.9	60.53	43.70

* "Real" hourly and weekly earnings: Actual earnings adjusted to changes in the cost of living since 1944.

These figures make it plain that the decline in the buying power of average weekly earnings between 1944 and the first half of 1950, which Mr. Ruttenberg mentions, was due entirely to a drop of 5.3 hours in the number of hours worked per week, from the abnormal wartime level of 45.2 to a normal peacetime basis. As disproof of our statement, Mr. Ruttenberg's reference to the 1944 situation is faulty because the higher buying power enjoyed in 1944 was not due to a higher real wage rate, but simply to longer hours of

work and overtime premiums. The fact is the buying power of the average hourly wage increased from 1944 to the first half of 1950 by approximately 5 per cent. (This figure makes no allowance for the higher pension and insurance benefits, paid vacations and other indirect wage increases granted between 1944 and 1950, which if included would make the workers' gains substantially greater, and which of course add to the employer's costs.) If factory employes had worked as many hours per week as in 1944 and received overtime pay on the same basis, the buying power of their weekly pay in the first half of 1950 would have been 10 per cent above the 1944 average.

Mr. Ruttenberg has nothing to say about working longer hours. It is interesting to note, however, that average work time has been lengthening, and in September was one hour a week longer than in the first half of the year. This is a natural effect of the increased demand for labor. It gives workers more pay to meet the rise in living costs, but in return for more work.

The arguments of union leaders shift very easily from weekly to hourly pay, and back again, depending upon which best suits the case at the moment. During periods of increasing employment, a lengthening work week, and a rising cost of living, all of which typically occur together, the habit when seeking wage increases is to minimize the weekly pay and emphasize the hourly pay, because in the circumstances the hourly rates will look lower in relation to living costs than the weekly pay looks. Under the opposite circumstances the reverse is true, and the decline in weekly pay which occurs as hours shorten is emphasized as a justification for higher hourly rates. But from the standpoint of the inflationary danger, the hourly rate is the signficant figure because it is the measure of labor costs. If the hourly rate goes up (without, of course, an equivalent increase in man-hour output) industrial costs rise, prices have to be marked up, and the spiral turns. If the weekly pay goes up solely because longer hours are worked the inflationary consequences do not follow.

Productivity Gains Shared

Mr. Ruttenberg says that management "obviously" has failed to share with wage earners or the consuming public the benefits of increased productivity per man-hour. With all respect, this is far from "obvious". The record shown in the above table is one of increasing buying power of the average hourly wage, in other words a rising standard of living for workers in return for a given amount of labor. Any group of the population which experiences this rise in its standard of living is necessarily sharing in the benefits of higher productivity. From 1948 to early 1950 the sharing took the form not only of higher hourly wages, but of lower prices. At the same time the workers have had the very substantial "fringe" benefits, not covered by the statistics.

The argument that higher wages can be paid out of profits without price increases requires so much space for discussion, and has been dealt with so frequently in this Monthly Letter, that we can only refer to some of our discussions in the past.* Corporation profits are not distributed equally, and there are always many companies which cannot pay higher wages without obtaining higher prices. Profits are a minor factor in the cost of sales, as compared with wages and salaries. Mr. Ruttenberg's argument on profits has been used to justify every demand that the unions have made for higher pay for years past. The fact is that it has never worked that way, not because of corporate greed, but because of the influence of a simple economic force, namely, increased costs.

Who Bears the Defense Burden?

The heart of the question is touched by Mr. Ruttenberg when he asks whether we "would want to see wage and salary earners bear the major burden of the mobilization program." Any person with a sense of fairness and good will would answer in the negative. The facts, however, do not warrant the question. It is plain from the figures that the repeated wage increases granted during the post-war period have raised the buying power of workers' wage rates by 5 per cent since 1944. Increases granted since the first half of this year, even when averaged over the whole body of factory workers, have almost though not completely offset the cost of living increase. The wage increases still to come may be expected to raise buying power further — an immense number of workers have had increases since the statistics were compiled, and more raises are demanded.

Despite Mr. Ruttenberg's contention that current wage increases are based on fairness and equality of sacrifice, even casual consideration will convince most people that other motives are dominant. Manufacturers recognize present or impending labor shortages, and the unions seek what the market will bear. The unions make demands, manufacturers grant increases (possibly because of contracts tied by escalator

* "The Nathan Report on Wage Policy", Jan. 1947; "Are Profits Too High?", Nov. 1947; "Congress Hearings on Profits", Jan. 1949; "The Arguments About Profits", April 1949; "Fourth Round Wage Demands", July 1949.

clauses to the cost of living index), and competitors follow suit to protect their own people and their own labor requirements. But however explained, the fact remains that the process is inflationary, and that the effect — contrary to Mr. Ruttenberg's fear that workers must bear the burden of defense costs — is to permit workers to escape the burden. They do so because through higher rates they preserve their own buying power. But if they do this in a time of a drop in the total product available for civilian consumption, as is now expected, they do it at the expense of other people, notably pensioners, everyone living on a fixed income, and everyone whose money income advances less than living costs. Sustained buying power means one thing: command over an unchanged quantity of goods and services. If the total quantity is lower, and one group takes the same, other groups have less. The principle of equity of sacrifice is violated. The buying power of the groups which suffer is diminished through inflation of prices. The evil of inflation is that it creates these inequities, distorts prices and incomes, and sets up untenable relationships which eventually break down in reaction and disorder.

More than one observer, analyzing the current economic prospect, is confident that the country, with appropriate fiscal and credit policies, can combat the inflationary dangers of the armament effort successfully without disruptive interference of our free markets, except for one problem. The exception is in the wage sector. The question raised is a grave one. Is it possible to avert a damaging inflation without (1) exercise of voluntary restraint by the union leaders or (2) firm wage controls? If the latter should become necessary, most people will agree that price controls also would be established, and that the country would be back in the O.P.A. days of grievous memory.

Third Quarter Earnings

Corporation earnings statements for the third quarter issued up to the time this Letter goes to press reflect the surge of scare buying by consumers and business touched off by the Korean war and superimposed on the business boom already in progress. Military contracts are not yet a major factor.

New peace-time or all-time peaks were set in the output of the steel, automobile, and numerous other manufacturing industries, as well as in building construction and retail trade. Total national income and most of its principal components rose to the highest marks in the country's history.

Many of the manufacturing industries were swamped by a demand far exceeding productive capacity, despite the extensive plant expansion and modernization programs carried out since the war. Industries forced to allocate supplies and push further additions to plant capacity include steel, nonferrous metals, textiles, chemicals, rubber, building materials, pulp and paper, automobiles and various types of machinery. The television industry continued its outstanding growth, with output this year estimated at 6,500,000 sets, or more than double the 3,100,000 produced in 1949.

In contrast with this expansion, some of the other manufacturing industries, such as food products, tobacco, clothing, office equipment, railway equipment, etc., experienced relatively little increase in volume of sales this year, and consequently many companies found their profit margins squeezed by rising costs and taxes.

The large increase in railroad freight traffic and revenues resulting from the business boom has brought a further recovery in net income from the relatively low level prevailing in the first nine months of 1949 and during the coal strike in the first quarter of 1950. Electric light and power systems reported a further growth in output and in gross revenues, although the gain in net income over a year ago was at a lower rate in the third quarter than during the first and second.

Our tabulation of the published reports of 500 companies, representative for the most part of the larger manufacturing organizations but including also a limited number in the mining, trade, and service industries, shows for the first nine months a combined net income of approximately $4.1 billion, up 37 per cent from the same period of 1949. The reports indicate in most instances that the 1950 figures are after deduction of federal income taxes and surtaxes at the increased rates imposed by the Revenue Act of 1950, which means before allowance for any excess profits taxes that might be enacted later and made retroactive. In spite of the widespread improvement during the first nine months of this year, about one out of every five of these companies experienced lower net income.

For the third quarter alone, net income of the group totaled $1.6 billion, up 54 per cent from the third quarter of 1949, with about five out of six individual companies showing increases. The trend in the quarterly totals for the two years was as follows:

	1949	1950
First quarter	$1,043,000,000	$1,133,000,000
Second quarter	926,000,000	1,404,000,000
Third quarter	1,011,000,000	1,561,000,000
Fourth quarter	1,144,000,000	—

NET INCOME OF LEADING CORPORATIONS FOR THE THIRD QUARTER AND FIRST NINE MONTHS

(In Thousands of Dollars)

No. of Cos.	Industry Groups	Reported Net Income Third Quarter 1949	Reported Net Income Third Quarter 1950	Per Cent Change†	Reported Net Income Nine Months 1949	Reported Net Income Nine Months 1950	Per Cent Change†
28	Food products	$ 38,673	$ 46,484	+20	$ 112,346	$ 118,870	+ 5
12	Beverages	12,666	28,042	+..	39,872	54,300	+36
13	Tobacco products	17,749	19,292	+ 9	47,178	49,277	+ 4
33	Textiles and apparel	22,142	50,023	+..	67,149	127,038	+89
27	Pulp and paper products	14,621	31,273	+..	50,705	80,954	+60
34	Chemicals, paint, etc.	108,846	203,132	+87	315,178	504,126	+60
13	Drugs, soap, cosmetics	34,809	39,944	+15	62,841	101,456	+61
20	Petroleum products	222,907	358,040	+61	726,294	861,414	+19
21	Cement, glass, and stone	38,375	49,872	+30	98,171	130,175	+33
31	Iron and steel	94,477	159,584	+69	340,909	449,579	+32
12	Building, heating, plumbing equipment	12,014	20,079	+67	30,204	47,989	+59
22	Electrical equip., radio, and television	51,136	90,619	+77	146,208	244,970	+68
36	Machinery	16,409	30,863	+88	57,731	80,158	+39
9	Office equipment	14,336	15,916	+11	44,095	46,189	+ 5
8	Automobiles and trucks	203,179	223,904	+10	516,290	725,936	+41
20	Automobile parts	25,346	38,257	+51	64,139	94,505	+47
9	Railway equipment	5,196	9,763	+88	24,465	23,791	— 3
52	Other metal products	25,155	51,013	+..	65,451	126,651	+94
26	Miscellaneous manufacturing	11,137	22,751	+..	35,996	58,406	+62
426	Total manufacturing	969,173	1,488,851	+54	2,845,222	3,925,284	+38
38	Mining and quarrying*	24,941	47,247	+89	87,665	115,177	+31
23	Trade (retail and wholesale)	10,811	17,926	+66	29,532	38,180	+29
13	Service and amusement industries	6,072	6,683	+10	18,019	18,401	+ 2
500	Total	$1,010,997	$1,560,707	+54	$2,980,438	$4,097,042	+37

* Before depletion charges in some cases. † Increases or decreases of over 100% not computed.

The accompanying summary shows by a number of major industry groups the highly uneven changes in the comparative net income as reported, but before allowance for any excess profits taxes that might apply to the year 1950.

Sharp percentage increases in the dollar earnings of many industry groups this year reflect not only the great expansion already noted in demand for their products, together with higher selling prices in many instances, but also the benefits of lower production costs from recent modernization of plant and equipment, and the substantial enlargement made in total invested capital. Moreover, the present earnings comparisons are with a period of business slump last year, when earnings in some industry groups declined by as much as 50 per cent from the preceding year. In the first nine months of 1949 there were deficits reported by 41 companies in this group of 500, whereas in the same period of 1950 there were but 8 deficits.

Corporate Earnings and Total National Income

Despite the recovery in corporate earnings this year, they represent no larger share of total national income than in 1948. The following summary, based on Department of Commerce computations with totals for the year 1950 estimated, shows the great expansion that has taken place in total payments for compensation of employes and in other important components of national income.

Total National Income and Its Principal Components

(In Billions of Dollars)

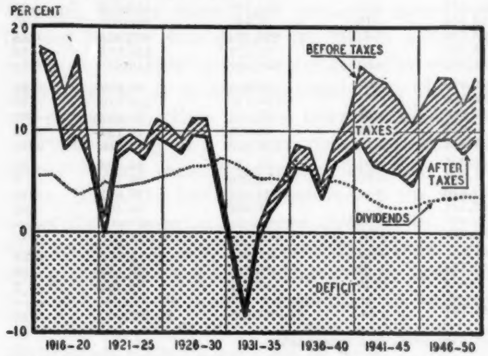
Year	Total Natl. Income	Compensation of Empl.	Business & Professional	Farm Income	Rent & Interest	Corporate Income Before Taxes	Corporate Income Taxes	Corporate Income After Taxes	Corporate Dividends Paid
1929	$87.4	$50.8	$ 8.3	$ 5.7	$12.4	$ 9.8	$ 1.4	$ 8.4	$ 5.8
1930	75.0	46.5	7.0	3.9	11.0	3.3	0.8	2.5	5.5
1931	58.9	39.5	5.3	2.9	9.6	—0.8	0.5	—1.3	4.1
1932	41.7	30.8	3.2	1.7	7.9	—3.0	0.4	—3.4	2.6
1933	39.6	29.3	2.9	2.3	7.0	0.2	0.5	—0.4	2.1
1934	48.6	34.1	4.3	2.3	6.8	1.7	0.7	1.0	2.6
1935	56.8	37.1	5.0	4.9	6.8	3.2	1.0	2.3	2.9
1936	64.7	42.7	6.1	3.9	7.2	5.7	1.4	4.3	4.6
1937	73.6	47.7	6.6	5.6	7.5	6.2	1.5	4.7	4.7
1938	67.4	44.7	6.3	4.4	7.6	3.3	1.0	2.3	3.2
1939	72.5	47.8	6.8	4.5	7.7	6.5	1.5	5.0	3.8
1940	81.3	51.8	7.7	4.9	7.7	9.3	2.9	6.4	4.0
1941	103.8	64.3	9.6	6.9	8.4	17.2	7.8	9.4	4.5
1942	137.1	84.9	12.6	10.5	9.3	21.1	11.7	9.4	4.3
1943	169.7	109.2	15.0	11.8	9.5	25.1	14.4	10.6	4.5
1944	183.8	121.2	17.2	11.8	9.6	24.3	13.5	10.8	4.7
1945	182.7	123.0	18.7	12.5	9.3	19.7	11.2	8.5	4.7
1946	180.3	117.1	20.6	14.8	9.5	23.5	9.6	13.9	5.8
1947	198.7	128.0	19.8	15.6	10.6	30.5	11.9	18.5	6.6
1948	223.5	140.2	22.1	17.7	11.6	33.9	13.0	20.9	7.5
1949	216.8	140.6	21.0	13.4	12.0	27.6	10.6	17.0	7.8
1950e	232.0	147.5	23.5	13.5	12.5	35.0	14.0	21.0	8.4

Source: U. S. Department of Commerce. — Deficit. e — Unofficial estimate.

Upon an assumed national income approximating $260 billion this year, the estimated corporate income before taxes would represent about 15 per cent. This would be around the same levels as 1947 and 1948, and 1941-45 during World War II, but below the peak levels of World War I.

Net income after taxes in 1950 will apparently be close to 9 per cent of national income — likewise around the same levels as 1947-48 and other years of peak business activity. The ratios for corporate income, both before and after taxes, represent but a small share indeed of the total national income as compared with the 64 per

cent for all wages, salaries, and other employe compensation. The relationship between corporate earnings and dividends, and total national income may be seen from the accompanying chart based on figures back to 1929 from the Commerce Department, and for 1916-28 from the Treasury Department and the National Bureau of Economic Research.



Total Corporate Income, Before and After Income Taxes, and Dividends Paid, as Percentages of Total National Income, 1950 Figures Partly Estimated.

It is noteworthy that of the total corporate net income, less than one-quarter is being paid as dividends to shareholders. Estimated dividend payments in 1950 represent only 3.6 per cent of the national income, about the same as in 1949. While this is slightly higher than in the years of the middle 1940s, it is much lower than in the 1920s, or even in the depressed 1930s.

The major portion of earnings in 1950, as in every one of the years since the war, is not being paid to shareholders but is being reinvested in the business. It is being used to build up working capital and to finance the replacement and expansion of plant and equipment, which because of the rise in wage rates and material prices cost much more than prewar. Such replacements also cost much more than the accrued depreciation reserves which are generally charged on the basis of original rather than present-day costs.

Whereas the managements of many companies thought six months or longer ago that their expensive postwar expansion programs had been practically completed, the upsurge in demand following Korea has forced them to resume on a large scale their capital outlays for further increases in capacity. The current expansion, like that during 1945-49, is being financed to a major extent from the reinvestment of earnings, thus avoiding the high cost of equity financing in the present investment market, and holding down the growth of bank credit or other borrowing.

What Is a "Fair Return"?

The question of what constitutes a "fair return" on capital is an old yet ever-fresh topic for argument. Labor unions in their disputes with management over the division of the income dollar, politicians currying public favor by playing upon popular prejudices, and agitators seeking to undermine the profit system, are constantly harping on the theme that business makes too much money. While public opinion polls indicate that most people have only the foggiest — and generally an exaggerated — idea of what the average concern really makes on its capital year in and year out, they reveal a tendency to think of some yardstick of "fair return".

Except, however, for public utilities such as the railroads, electric light and power companies, telephone companies, etc., where there is in greater or less degree some element of monopoly by public consent, and for industry generally during wartime, this country has never accepted the principle of placing a ceiling upon earnings. The theory has been that anyone could take what capital he had and go into business to make what he could in the rough and tumble game of competing for public patronage. If he could do something or make something that the public wanted, better or cheaper than anyone else, he was entitled to whatever rewards his energy, ability, and initiative would bring. This is the theory upon which the industries of this country have been built.

Nevertheless, the urge to regulate profits in accordance with what someone thinks ought to be a "fair return" has occasionally threatened to get the upper hand. War offers a convenient opportunity for introducing the principle of profit regulation under plea of "taking the profit out of war". One way to do this is by what is really a "high profits tax" masquerading as a "war profits tax".

As we pointed out in these columns a month ago, there is a great deal of difference between the two. Whereas a true "war profits tax" aims only to tax profits due to war, a "high profits tax" would tax *all* profits above a line arbitrarily determined upon as representing "average earnings" or a "fair return" on investment. The first tax is simple at least in concept, and is related to war business. The second tax involves a philosophy of profit regulation having no necessary connection with the war emergency, and might prove to be an entering wedge for a permanent system of profit control.

The Problem Today

Fortunately, this country has remained firmly opposed — save for the exceptions noted earlier — to any attempt to lay down arbitrary rules as to what constitutes a "fair return" on capital and to regulate profits accordingly, either by price controls or by "excess profits" taxes. Now, however, "fair return" comes up as a practical question in connection with proposals for an excess profits tax to help finance the rearmament program.

Because of the recognized inequities of applying such a tax to all earnings in "excess" of some prewar average (such as 1946-49), which would heavily penalize rapidly growing concerns and those whose earnings were abnormally depressed in the base period, it is proposed to allow business concerns the alternative of applying the tax to the "excess" of earnings over a "normal" or "fair" return on capital. This was the choice given in the excess profits taxes of World Wars I and II.

But again the question, what is a "normal" or "fair" return on capital?

What Is Not a "Fair Return"

In the excess profits tax in effect at the end of World War II, for companies using the invested capital base method, the "credit", or rate of return allowed before earnings were taxed as "excess profits", was —

invested capital of $5,000,000 or less	8 per cent
invested capital between $5,000,000 and $10,000,000	6 " "
invested capital over $10,000,000	5 " "

These figures, however, represented an allowable rate of return *before* federal normal and surtax amounting to 40 per cent. Thus the corresponding net return *after* taxes represented a rate of only 4.8 as a maximum down to 3 per cent as a minimum.

The excess profits tax proposed by Senators O'Mahoney and Connally when the Revenue Act of 1950 was under consideration would have provided substantially the same scale of credits as in 1945 for companies using the invested capital base.

Without attempting to say what constitutes a fair return, such rates after the present 45 per cent normal and surtax certainly would not be a fair return.

They are well below the standards of "fair return" which Congress itself and various federal and state regulatory authorities have established for the purpose of regulating rates for the railroads, the airlines, and for the electric light and power companies and other utilities. Under the original Transportation Act of 1920, the Interstate Commerce Commission set the yardstick of fair return for the railroads at 5¾ per cent *after* taxes on the property investment, though actually the railroads have never, under regulation, realized this rate. The Civil Aeronautics Board, in fixing mail rates for the air transport companies, has often used the figure of 7 per cent after taxes as a fair return. For the electric utilities, state regulatory bodies have approved rates to customers that would yield returns ranging from 5 per cent to more than 6 per cent — and this again is *after*, not *before*, taxes.

In fact, under the low yardsticks of return prescribed by the tax law during World War II, many of the utilities found themselves in the strange and uncomfortable position of having to pay excess profits taxes, even though as regulated industries they are not supposed to have excess profits.

Return in the Manufacturing Industries

In the case of the manufacturing industries, the records of earnings of leading corporations which this Bank has regularly compiled for more than twenty-five years show that the average return in good or even fair years has been well above the scale provided in the excess profits tax laws of World War II and again advanced by the proponents of the O'Mahoney-Connally amendment.

These tabulations of the publicly available reports of earnings after taxes of approximately 1,500 manufacturing corporations, summarized in the following table for selected four-year periods, show that fixing a rate of 8 down to 5 per cent, before taxes, and classifying everything above that as excess profits, would mean — for companies having to use the invested capital base rather than the average earnings base — taking away a large share of peacetime earnings.

The rates of return shown in this summary are based on net assets or shareholders' equity, and thus are not strictly comparable with the rates of return on "invested capital" as defined in the tax laws of World War II, which added an allowance of 50 per cent for borrowed capital. Nor are they strictly comparable with the rates of return used by most government regulatory commissions, which are based not on capitalization but upon property investment. When the earnings are applied to a base broader than the shareholders' equity, the percentage return is lowered

Average Annual Percentage Rates of Net Income After Taxes to Net Assets of Leading Manufacturing Corporations in Selected Four-Year Periods

	1926-29	1931-34	1936-39	1946-49
Baking	14.6	7.9	8.3	20.3
Dairy products	19.4	6.9	9.0	15.9
Meat packing	4.7	1.5	3.2	8.5
Sugar	3.6	2.2	4.5	12.2
Other food products	15.6	8.8	10.5	17.7
Soft drinks	25.5	14.8	34.6	19.6
Brewing	*	*	15.6	22.7
Distilling	*	*	14.2	27.4
Tobacco products	14.0	11.7	12.8	13.2
Cotton goods	3.3	—0.7	2.9	26.2
Silk and rayon	4.9	3.1	9.0	23.2
Woolen goods	—3.0	—2.6	0.4	18.1
Hosiery, knitted goods	11.3	0.4	6.4	21.2
Other textile products	8.4	1.0	7.4	20.6
Clothing and apparel	12.1	—0.1	7.1	16.3
Leather tanning	1.2	—1.6	1.5	12.2
Shoes, leather products	14.0	5.7	6.8	13.5
Tires, rubber products	4.7	0.2	7.7	14.9
Lumber	5.8	—5.5	3.8	21.7
Furniture, wood products	5.7	—2.8	8.8	14.1
Pulp and paper products	7.9	—0.1	5.2	17.5
Printing and publishing	18.2	6.3	8.3	16.9
Chemical products	14.0	7.6	12.7	16.5
Drugs, soap, cosmetics	21.6	13.0	17.6	19.9
Paint and varnish	11.3	4.1	7.9	14.3
Petroleum products	9.3	0.9	7.1	15.5
Cement	9.3	—1.7	5.8	14.2
Glass products	9.6	5.6	13.5	16.7
Other stone, clay products	9.5	—0.1	7.4	15.9
Iron and steel	7.7	—1.7	4.0	11.1
Agricultural implements	11.5	—2.0	9.3	11.8
Bldg., heat., plumb. equip.	12.7	—2.0	6.5	16.0
Elec. equip., radio and tv.	15.2	0.6	10.7	16.5
Hardware and tools	16.3	—2.2	10.9	14.9
Household appliances	14.8	4.1	11.1	23.6
Machinery	10.9	—3.0	10.0	15.0
Office equipment	16.6	3.9	14.3	22.5
Nonferrous metals	10.2	0.1	7.7	11.1
Other metal products	13.6	5.2	9.1	13.4
Autos and trucks	25.6	4.1	16.6	21.1
Automobile parts	18.3	0.5	12.1	18.7
Railway equipment	8.1	—0.8	3.2	9.3
Aircraft and parts	*	—3.1	12.9	2.2
Shipbuilding	1.3	—0.2	5.4	12.9
Misc. manufacturing	13.1	4.5	11.1	14.5
Total manufacturing	11.1	2.2	8.6	15.5

– Deficit. * Not computed because of limited number of reports available for the group.

correspondingly; however, in most of the manufacturing industries the fixed debt is not a large factor.

Wide Variations in Rates of Return

One need only note the great variation in earnings experienced by the different groups to appreciate the absurdity and risks of applying the strait-jacket of a single measure of fair return to the almost countless variety of different industries and individual companies, with their widely differing financial fortunes.

Some companies tend normally to show high rates of return because of needing only a relatively small capitalization. Others in lines subject to sharp ups and downs must make high rates in good years in order to offset losses in poor years, such as the period 1931-34 shown in the table. Still others show high rates on the valuation of their tangible property because of the fact that their most valuable assets are intangibles in the form of goodwill, trade names, etc.

High rates of return often reflect a rapid rate of growth tending to outstrip capitalization, in which case the high return is economically justified as necessary to attract new capital. On the other hand, companies that are overcapitalized and unprogressive usually have relatively low rates of return, and thus would enjoy a large excess profits tax exemption.

The invested capital base becomes even more unfair when marked changes occur in the general price level, as has happened since 1940. The average rates shown for 1946-49 were substantially higher than in the corresponding periods of the 1920s and 1930s not only because of the great expansion that took place in the physical volume of production, plus the inflation of dollar sales by the price rise, but also because the net income as reported in the late 1940s reflected depreciation charges based generally upon original rather than replacement costs of plant and equipment, and because the percentage return was computed upon net assets based upon balance sheet values which are far below present-day values.

Accounting Difficulties

Besides these objections to the very idea of setting up such low arbitrary limits of fair return, there are all sorts of complicated accounting problems involved in allowing for such technicalities as the original cost of assets, accrued depreciation charges, mergers and reorganizations, property write-downs and write-ups, recapitalizations, contingency and other reserves, etc., which become causes of dispute for many years. We referred last month to the fact that there are claims totaling $7 billion on excess profits taxes still unsettled from the war which ended more than five years ago, and to the fact that such delays are particularly hard on the small business man who frequently cannot afford to keep up the fight.

On the latter point, a letter just received from a small business man in Steamboat Rock, Iowa, comments feelingly as follows:

> Small business like ours creates its capital entirely out of earnings saved and plowed back into the business and this tax absolutely prevents it. We paid an excess profits tax in 1942 and I am still trying to get it back as I feel the law applied unjustly in our case. When I was in Washington, D. C., on the matter they admitted I was right but wanted 'evidence' which can't be obtained so I am still waiting, altho I have spent more than I'll ever get back now in trying to recover the tax paid.

The Real Criterion

The fact is that a fair return on capital is not something that can be dreamed up by some

theorist or determined arbitrarily by legislative action or by the rulings of government boards and commissions. The real criterion is the very practical test of what rate it takes to attract capital.

This varies in almost infinite degree according to the uses to which capital is put and the conditions under which such usage takes place. It is necessary only to look at the widely different "yields" prevailing on securities in the stock market to get the point. For well established companies in relatively stable industries the investor may be satisfied with a return of 5 or 6 per cent on his money. For other companies entailing more risk — either because of less intrinsic merit or because subject to wider cyclical fluctuations — he may demand yields of 10 per cent or more to induce him to buy.

In still other cases where a well regarded company is believed to have good prospects for rapid growth, the investor may be willing to buy on a 2 or 3 per cent current yield basis — but only because of the expectation that future earnings of the company will rise substantially and bring a much higher net return to the investor through capital appreciation.

Finally, many investors will be willing to risk their money in new and untried ventures that yield no immediate return at all — but here again it is only because they can look forward to high returns later on, commensurate with the risk, if the ventures pan out successfully. No one is going to put capital in such ventures, with all the danger of total loss, if all he can hope for is that the enterprise might earn a mere 5 per cent, or even 8 per cent on its capital — and this before taxes at that! It is the hope of doubling and trebling one's money that makes such venturing worth while.

In short, to the question, what is a fair return on capital?, there can be no precise answer.

A Bad Tax

All this only goes to show the more strongly why the excess profit tax, with its arbitrary standards of "fair return" and other defects, is a bad tax.

Unless the industries of this country are permitted to earn a rate of return that will foster incentive and attract capital, growth will be stultified and the "mature economy" we used to hear so much about in the '30s will be here with a vengeance. For a brief emergency period, the evils of this tax may be supportable. But in a long drawn-out rearmament program of the magnitude and duration that we seem to be facing, the cumulative effects could be extremely serious. Not only the future of the private enterprise system, but the security of the country itself, depends on our maintaining the vigorous dynamic growth which has been responsible for our high standard of living and which played so decisive a role in winning the war.

No one contends that corporations should not be taxed to help pay for the defense program. The only question is, how much and by what methods? Already the corporate normal and surtax has been raised to the point where the Government next year will be taking 45 cents in taxes out of every dollar of corporate earnings. Because of the recognized weaknesses of the excess profits tax — its discouragement to enterprise, its encouragement to corporate waste and extravagance, and its headaches of administration, with all the necessary but complicated "relief" clauses — the suggestion has come from several sources that any additional taxes levied on the corporations might better take the form of a temporary "defense" tax applied straight across the board. Such a tax would avoid the pitfalls of trying to distinguish between "excess" and "normal" profits, and would be simpler in administration and compliance.

But of course there are many forms of taxes other than those on corporate income that should be considered as well. A tax on a corporation is a tax on production at a time when we vitally need more production. The logic of the present situation calls for a tax on spending — in other words, excise taxes and sales taxes.

Best of all would be a further cutting of nondefense government costs — for every dollar of government expenditure saved means one dollar less that will have to be raised by taxes, whether upon corporations or individuals.

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